Internal Revenue Service

memorandum

CC:TL:Br2
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date: MAR 15 1989

to: Deputy Regional Counsel (TL) CC:C

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: Action on Decision in Truesdell v. Commissioner
89 T.C. 1280 (1988)

This is in reply to your memorandum of December 27, 1988, asking us to reconsider Truesdell v. Commissioner, AOD CC-1988-025 (September 12, 1988). Your request has its inception in a memorandum prepared by Revenue Agent Allen B. Johnson that recommends we withdraw our acquiescence in the Truesdell decision.

ISSUE

Whether funds diverted to the shareholder of a wholly owned corporation should be regarded as constructive distributions taxed in accordance with I.R.C. § 301(c), where the funds were not additional salary or otherwise received in a nonshareholder capacity.

CONCLUSION

Funds a shareholder diverts from his wholly owned corporation to himself as a shareholder should be regarded as constructive distributions. Pursuant to section 301(c), such distributions are ordinary income only to the extent of available earnings and profits. We continue to acquiesce in Truesdell.

DISCUSSION

We are sending you with this memorandum a copy of Truesdell v. Commissioner, OM 20148, I-030-88 (August 3, 1988). That OM was prepared by the former Interpretative Division in response to a memorandum in which we proposed acquiescing in the Truesdell decision. The OM explains the legal foundation for the Truesdell AOD.

In this memorandum we would like to respond in a less formal manner to the concerns raised. In other words, we have left it

to the OM to explain the legal precedents, and are using this memorandum to explain our resolution of the issue from a conceptual perspective.

The key point you raise is that a distribution must be made by a corporation "with respect to its stock" under section 301(a) before its taxability is governed by section 301(c). Only distributions that relate to the stock will be considered first as dividends to the extent of available earnings and profits, then as a nontaxable return of basis, with any excess being treated as capital gain.

You believe corporate distributions are not made by the shareholder in his capacity as a corporate figure, but in his individual capacity. Mr. Johnson expresses this concern, in part, as follows:

> A corporation is an inanimate object and is able to act only through its officers, employees and agents. A sole shareholder who is actively involved in directing the affairs of his corporation has to wear two hats, it is the nature of the beast. However, he can not wear both hats at the same time. He must be acting either on behalf of the corporation or on behalf of himself; these are mutually exclusive positions. A person who diverts corporate funds from reaching the corporation cannot be said to be acting on the behalf of the corporation. At the point in time that he obtains the funds he has the ability and control to take one of two routes. He can make the corporation aware that it has received funds at which time the funds would be noted in the corporate records and the funds would be made available for corporate purposes. The other option that the person has is to secrete those funds from the corporation and convert them to his own personal use and deny the corporation the knowledge and benefits of those funds.
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> The issue is not stock ownership but rather dominion and control over the monies. Dominion and control are certainly not predicated on stock ownership.

We have a different perspective on this matter. We believe a corporation and its shareholders have a common objective -- to

earn a profit for the corporation to pass onto its shareholders. Especially where the corporation is wholly owned by one shareholder, the corporation becomes the alter ego of the shareholder in his profit making capacity. This is not to say the corporation and its sole shareholder are inseparable under the law, only that a sole shareholder and his corporation have common objectives so that the shareholder need not act in one role or the other. Moreover, by passing corporate funds to himself as a shareholder, a sole shareholder is acting in pursuit of these common objectives.

Dominion and control are not determinative of whether a distribution constitutes a dividend, a return of capital, or capital gain. By its very nature a distribution to a shareholder gives that shareholder dominion and control over the monies distributed. The issue is what was distributed. If earnings and profits were distributed to the shareholder, then dominion and control was obtained at the cost of ordinary income being increased by the amount of the distribution. However, if capital was returned to the shareholder, then dominion and control was obtained without taxation.

Likewise, intent is irrelevant. Under section 316, dividends are distributions made by a corporation to its shareholders out of earnings and profits. Except as otherwise provided, every distribution is considered to be made out of earnings and profits to the extent thereof. Then, the portion of the distribution that is not a dividend is applied against the basis of the stock with any excess being capital gain. In other words, every distribution made with respect to a shareholder's stock is taxable as ordinary income, capital gain, or not at all pursuant to section 301(c) dependent upon the corporation's earnings and profits and the shareholder's stock basis. The determination is computational and not dependent upon intent.

As we see it, a sole shareholder commonly has two relationships to a corporation. He is a shareholder, of course, but often he is an employee of the corporation as well. That was the situation in Truesdell, as Mr. Truesdell oversaw the daily activities of both corporations. In Truesdell, the Commissioner did not contend the diverted funds were additional salary, illicit bonuses, commissions, or other diversions attributable to his employee status. Therefore, since the diversions did not relate to his employee status, it is reasonable to conclude they related to his shareholder status or were made with respect to his stock.

We do not consider it arguable that Mr. Truesdell acted in his status as an individual, since his ability to obtain corporate funds grew out of one of his positions as a corporate insider. He received the funds as a corporate insider and he

diverted them to his own use as a corporate insider. If he was not acting as an employee, then he was acting as a shareholder.

Keep in mind that the diversion itself was lawful in Truesdell. There is usually nothing wrong in a sole shareholder taking corporate funds for his own use. What was unlawful was not reporting those funds as income of the corporation. What we are saying is that this is not like an embezzlement case where someone is arguably acting as an individual because their taking of funds was beyond the scope of their authority. Rather, as the sole shareholder of his corporations, Mr. Truesdell had full authority to apply corporate funds for his own use.

For these reasons, we believe the Sixth Circuit has gone too far in holding funds lawfully diverted to the sole shareholder of a corporation and not shown to be salary or otherwise received in a nonshareholder capacity are automatically ordinary income. Such funds should be considered ordinary income only to the extent of available earnings and profits as a matter of law and equity. Therefore, we have decided that in all jurisdictions, including the Sixth Circuit, funds diverted to the shareholder of a wholly owned corporation should be regarded as constructive distributions, unless the funds were additional salary or otherwise were received in a nonshareholder capacity.

As for the practical ramifications of administering the Truesdell approach, we admit the approach is burdensome and could result in more civil and criminal tax issues being resolved in the favor of taxpayers. Whenever a corporate distribution is in issue, the problems of determining the available earnings and profits and shareholder capital can become involved. Of course, that is especially true in criminal tax cases where the Government has the burden of proof. However, our job is to fairly and accurately interpret and apply the law regardless of whether the law is burdensome or involves a loss of revenue.

In this instance, there is a split of authorities as discussed in OM 20148. As a matter of law, we agree with the approach of the Second and Eighth Circuits that the Tax Court unanimously adopted in Truesdell. Therefore, we believe that approach should be applied in all circuits in the interests of fair administration of the tax laws. We appreciate the practical concerns associated with this approach, but do not feel those concerns are controlling.

We also do not believe the practical problems associated with following the Truesdell acquiescence are great. The acquiescence applies only to funds diverted by the sole shareholder of a corporation without being reported as income of the corporation. In those cases, we still may argue the diversion was in the nature of additional salary. Only if the

diversion was made in a nonemployee capacity would the nature of the diversion be dependent on earnings and profits. Moreover, even in those cases the burden of proof to establish the earnings and profits generally would rest with the taxpayer.

The problems are generally restricted to criminal tax cases where the Government has the burden of proof as to earnings and profits. Even in those cases, we believe that if the Government provides some evidence there were earnings and profits, such as recent profitable operations, we believe the courts would look to the defendant to rebut that evidence.

We refer you to the enclosed OM for a more technical analysis of our conclusion. Please do not cite the OM as authority or disclose its contents to persons outside of Counsel. Disclosure of the OM outside of Counsel will undermine our defense to production of OMs under the FOIA. However, we have no objection to your citing the cases or following the reasoning reflected in it to the District Director, Indianapolis or the members of his office in explaining our position on this matter.

In closing, we wish to thank Mr. Johnson and the rest of you responsible for bringing this matter to our attention for reconsideration. Although we have decided to continue acquiescing in Truesdell, we have found your thoughts on this matter insightful. We are neither infallible nor inflexible, so we appreciate well thought out submissions questioning our decisions.

Marlene Gross

MARLENE GROSS

Attachment:
OM 20148